

Stillwater Capital - This Week in the Markets



The Economic Top- Down

It was a quiet week on the economic front, with the lone exception being the August CPI report released on Wednesday. The trend has been flat and that hasn't changed, coming in with a modest 0.2% gain.

The Stillwater View: The search for inflation in the primary indicators like CPI and PPI remains elusive, with this print being the latest evidence of that fact. What can we say? At some point it should begin to pick up in a material way, and when it does, look for the Ten-year Treasury to yield something well north of 3.00%. Rates are headed higher...I think.

Finally, Possibly a Bottom in Rates?



Source: The Saint Louis Federal Reserve

The Bottom Up

Goldman Sachs and Stifel combined to rope-a-dope semiconductors this week, calling for a cyclical peak in memory pricing and capital expenditure spending that should begin in 2019 and last into 2020.

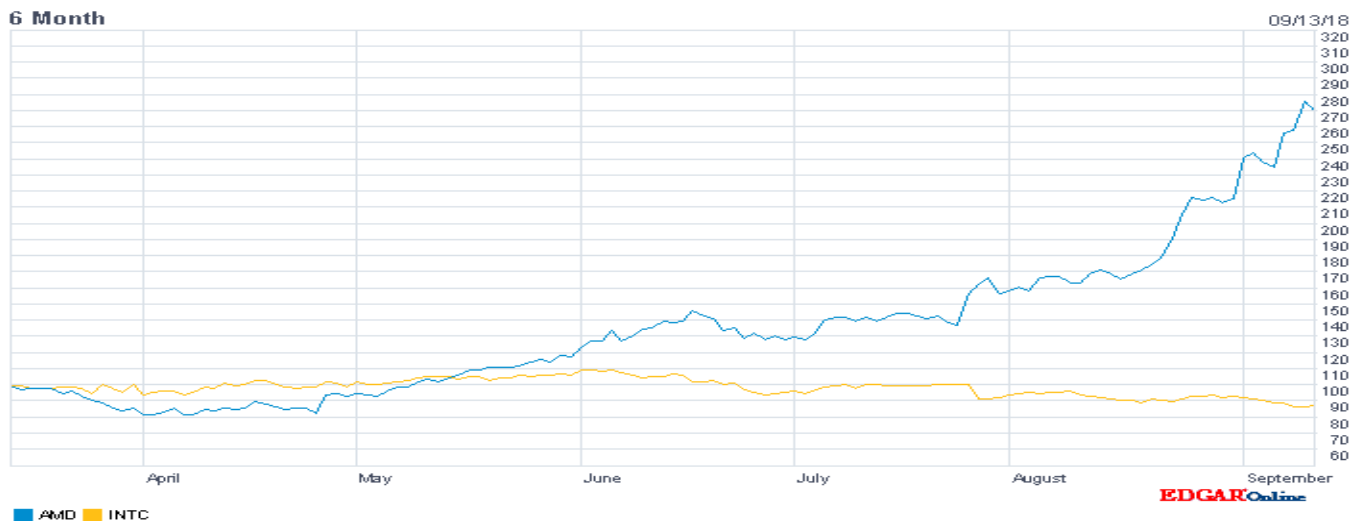
Philadelphia Semiconductor Index



The Stillwater View: The firm has been short the SMH for much of the year, and as of today we have a small gain, which in this market feels like a win. At the very least, the position has allowed our strategies to run at a lower net exposure to the market.

Since June, the monster trade that has performed well since May is to be long Advanced Micro Devices and short Intel. The former is up almost 300% and the latter is down 10%. This runs contra to what has worked for the better part of the past 20 years. AMD has recently received some very key design wins in the market for servers.

Advanced Micro vs. Intel

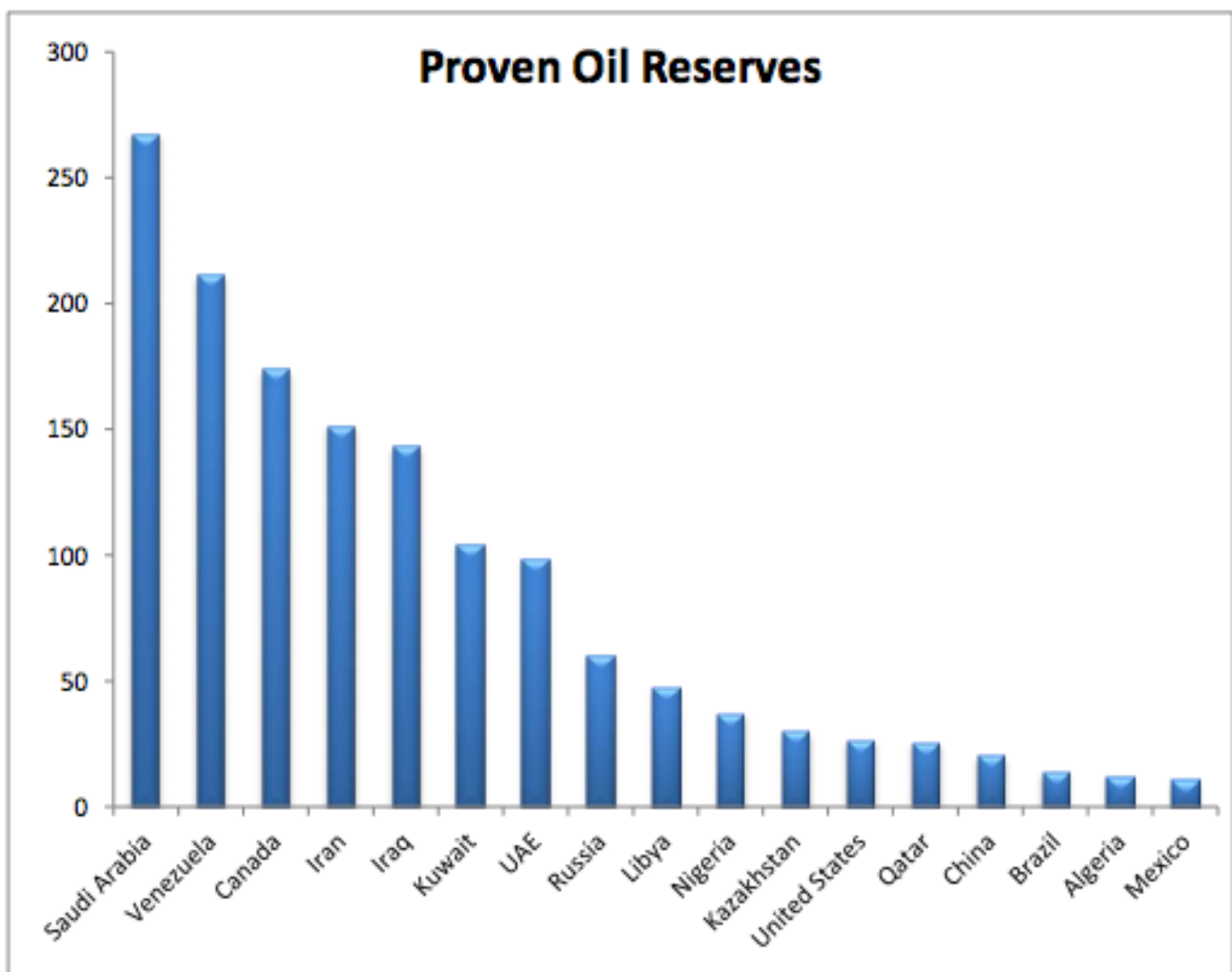


The Stillwater View: This simply never happens. It's like Shasta being better than Coke. A Yugo being worth more than a Ferrari. Polyester more comfortable than Egyptian cotton. The Red Sox more important to baseball than the Yankees. All of which are seemingly inconceivable.

The oil markets continue to attract attention this year with WTI hitting \$70 this week and Brent moving above \$80. This is due to a combination of strong global demand, supply disruptions in Iran, Iraq and Venezuela, and Saudi Arabia needing a reasonably high price to support austerity measures . The chart below shows why these four are so important.

Global Oil Reserves ex-United States

Figure 6: Proven reserves in billions of barrels



Source: EIA, RBC Capital Markets

Source: Energy Information Administration

OPEC meets later this month in Algiers and the risk of a production increase will perhaps keep a lid on prices for the moment. Taking all of this into consideration, two sided speculation continues with Again Capital's John Kilduff calling for \$20 dollars of upside.

Phillips 66, **National Oilwell**, **EOG**, **S&P 500**



The Stillwater View: We have been overweight oil via positions in oil service, transportation, refining and despite it all, have done reasonably well with the sector this year. After a flat start, the trade began to work as it was intended to beginning in April.

Markets

It was a big week for hedge fund billionaires and their opinions on where we are in the current economic cycle. Bridgewater founder Ray Dalio, called it the seventh inning, while Appaloosa's David Tepper said it was the eighth, adding that you can always go into extra innings.

Both have admitted to being too conservative with Tepper only 25% exposed on the long side. Stillwater has experienced the same frustration in our hedged strategies, as it's been two steps forward on the long side this year, and one step back on the hedges. That being said, we have had a pretty good short book in 2018.

Panther Owner Tepper with Coach Ron Rivera



Source: Sports Illustrated

The Stillwater View: We love them both and have a self-admitted manly crush on Tepper. In a world of smug and entitled hedge fund managers, he is most certainly not. He is also a proud American who isn't afraid to call it likes he sees it, taking a position against the president, just as Jamie Dimon also did this week.

Add Morgan Stanley to the list of those with a bearish outlook on the equity market, as they also came out swinging this week. In a research note to clients, the firm's chief equity strategist, Michael Wilson, wrote "We think this 'rolling bear market' has already begun with peak valuations in December and peak sentiment in January."

UBS, Goldman Sachs, and JP Morgan have also raised the red flag, mostly on policy risk emanating from 1600 Pennsylvania avenue.

The Bears Gather to Feast



Source: Nature.com

But be aware bears, as noble laureate Robert Schiller points out, even with stocks 'highly priced' they can still go higher. As Keynes once said, "The markets can remain irrational longer than you can remain solvent."

Room to Run Higher?

Houses vs stocks since 1991



Source: Federal Housing Finance Agency and Yahoo Finance

BUSINESS INSIDER

Source: Business Insider

Last week we brought you toy innovator Billy Ray Valentine, along with his friend and advisor Louis Winthrop III. When we introduced him, Billy Ray was making decent money and stocking away what he could for the future.

Instead of calling what he owned equities, we renamed it “awesome” because we didn’t want to cause fear or confusion. Billy Ray simply wanted to double his money in ten years, doing it by averaging a 10% return per year. To do that you need to take [Jack Bogle’s](#) advice and stay invested in the market, and not try to time every move.

Back to Billy Ray. After several years of growing sales in the niche G.I. Joe with the Kung Fu grip market, he sold his company to G.I. Jim, Inc. The deal netted him a cool \$10 million cash after paying the government its due. He also got a nice slug of equity in G.I. Jim.

G.I Joe With the Kung Fu Grip



Source: Beer Snob Squad

Having pulled off what most would consider to be a pretty nice payday, it was time for Billy Ray to sit down with his advisor Louis Winthrop III and talk about a new plan for his money. The conversation went something like this.

Louis: Billy Ray, remember that time years ago when I told you that the market for G.I. Joe With the Kung Fu grip was too small to ever make you any money? Well I was wrong. Like Really wrong. Nicely done my friend, nicely done.

Billy Ray: You are too kind Louis. Life is about taking risks. I took one and it paid off. And your crystal ball sucks!!! So what's our next move with my money? I have loved owning awesome and want to hear what else you have on the horizon.

Louis: Great question. First thing I want to emphasize is that you is that you have had a really nice liquidity event. And prior to this you were *heavily* exposed to your biggest investment,

and that was your company. As the saying goes, you make your wealth through concentration and maintain it through diversification.

Billy Ray: I like the way that sounds. Keep going.

Louis: Because of that payday we want to diversify you out of just awesome and into some amazing as well.

Billy Ray: Read me in on what amazing is.

Louis: Amazing is piece of paper that makes you a lender. You can lend to a company, a government, or a municipality. They pay you some money for the loan and at the end of the term you get your money back.

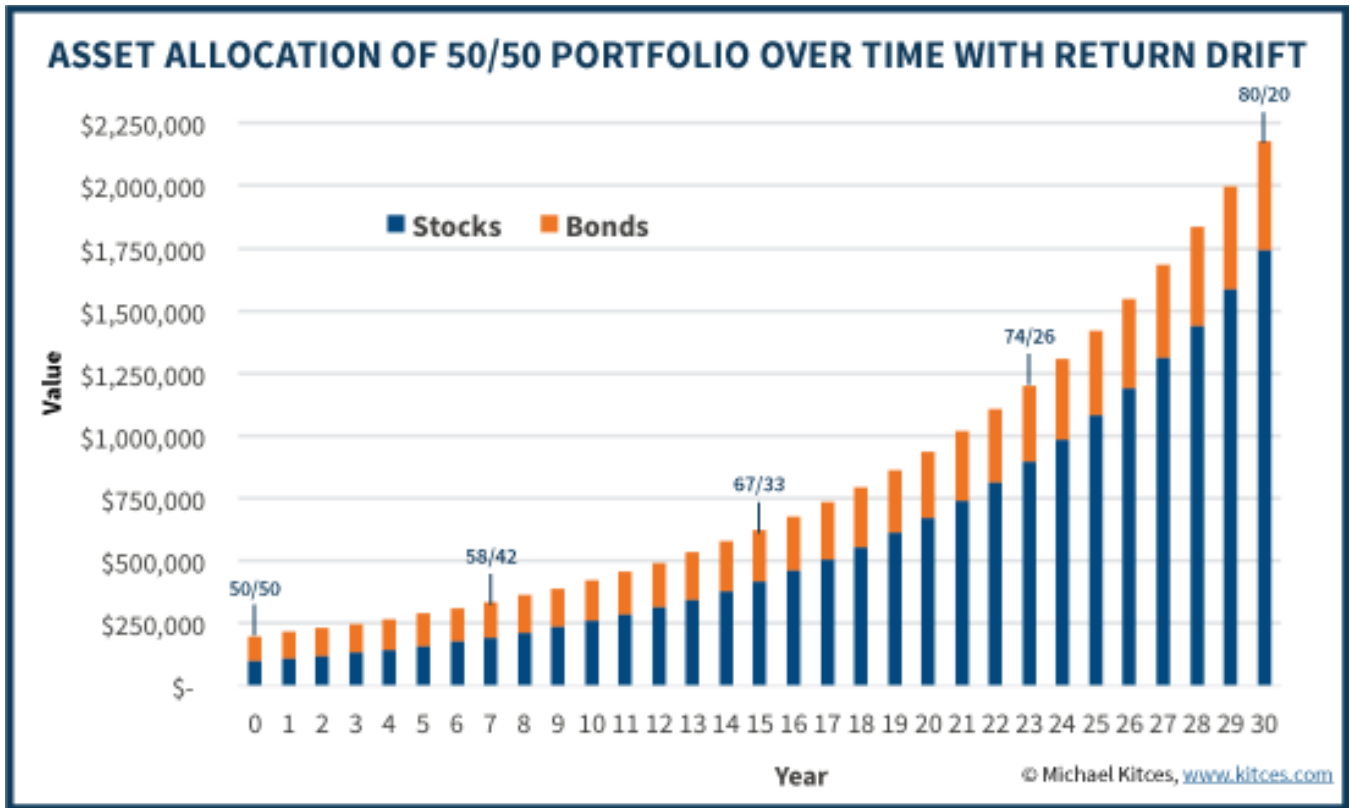
Bill Ray: All of your money?

Louis: Most of the time yes. That's the appeal. You get a nice income stream from amazing and then you get your money back. It also doesn't go down in value the same way amazing does. Think about it as ballast on a ship.

Billy Ray: Very cool. Let's spread my money around between amazing and awesome.

Louis: Alright, 50/50 right down the middle. Consider it done.

Stocks Are Amazing & Bonds Are Awesome



Source: Michael Kitces

The Stillwater View: Thanks once again for not rolling your eyes. We aren't trying to dumb this down too much. Just looking to demystify things and get your mindset out of the scary stock and bond markets and into what each does so very well. Next week, investing the Billy Ray Valentine Endowment for Kids With Problems.

Mr. Valentine, Meet Mr. Benjamin



Source: Big Media Vandals

Hedge Funds

In honor of the ten year anniversary of the unhooking of the US financial system, *Bloomberg Businessweek* looks back at three men who made big calls, made big money, and failed to do it again. At least for now. Einhorn, Howard and Paulson became billionaires when their calls that the great debt super cycle was about to come to an end and sub-prime mortgages would be at the epicenter. Just like most right tail events, there was a reversion to the mean and returns have been pedestrian ever since.

The Stillwater View: I was once lucky enough to be amongst a group of young and hungry gun slingers who came together under one magical hedge fund roof. The man who not only built the roof, but the whole house was Mark Strome. Mark was part rock star, part genius. Returning over 100% in 1993 and 1994 with huge macro bets that simply worked out in his favor.

Strome at Alma Matter Old Dominion



Source: Strome Family Foundation

The scene during those days was surreal. Envelopes of money would show up under the door with investors begging to get in. What we all didn't know at the time was that those two huge years were not repeatable. We too returned from the right tail to the left. While it was still a great run, the big money was gone.

Thanks Mark, for giving a fresh faced kid just out of undergrad the chance to run real money. In retrospect you were right, there were indeed times when I most certainly didn't know what the hell I was doing.

This week *Bloomberg* wrote what most would consider to be a eulogy for the Golden Age of hedge funds providing a picture of what might very well be their tombstone.

Here Lies The Body Of.....



The Stillwater View: Strategies should be willing to evolve and if they don't, they go the way of the dinosaur. There is very little difference between actively managed hedge funds and actively managed long only mutual funds. Both have been under assault from the machines that offer cleaner solutions at more favorable prices.

One comes in the form of quant funds, and the other from the ETF factory. The latter is low fee the former is high fee, but the performance is what validates the cost of admission. Exhibit A in the debate is the performance of James Simmon's beautiful machine.

Renaissance Medallion Fund – 1998 to 2016



Diversions - BurgerPalooza

This week we are shedding the usual mixed bag subject matter of *Diversions* and giving the hamburger the attention it deserves. We hope you came hungry.

The *San Francisco Chronicle* ran a piece that covered [“31 things you didn’t know about In-N-Out”](#). Highlights include pictures of Lynsi Snyder, the sole heir to the franchises fortunes. The 39 year old is worth more than \$2 billion. The article also reports that the average manager of one of the chains restaurants makes \$160,000 a year.

The In-N-Out Near LAX



Source: flickr

The Stillwater View: Are you serious? A smooth \$160k and benefits? So long alternative investments, daddy is going to go bark orders at a bunch of millennials who are trying to figure out how to work the potato splitter.

In a sign that we might very well have lost the War on Terror, the Mid-Western iconic purveyor of goodness, White Castle, debuted its first ever plant based burger this week.

Nooooooooo!!!!



Source: CNBC

Finally, we are going to get down to brass tacks with a discussion of which non-chain burger joint owns Los Angeles. There are two, and only two, establishments that can compete. Over in Westwood there is the legendary Apple Pan.

“Quality Forever”



Source: KCET

Across town in Pasadena sits the very old school, old guard, Pie 'n Burger.

"Cash Only...Please"



Source: Hoodburger

The Stillwater View: On paper this shouldn't even be a contest. The Apple Pan is a time capsule set in my old stomping grounds near UCLA. The interior is out of a movie set and the burger is beyond amazing.

Having said all of that, the combination of grilled beef, lettuce, tomato, special sauce, and a perfectly crisped bun makes Pie 'n Burger the champion. It is the closest thing to burger perfection the world has ever known. A true masterpiece!

Apologies to my good friend Warren who happens to disagree. What I just said is as true as the inevitability of death and taxes. Readers who have experienced both are welcome to chime in.

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